No. 21104

In the United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA, APPELLANT

v.

HASKEL ENGINEERING & SUPPLY COMPANY, APPELLEE

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN (NOW CENTRAL) DISTRICT OF CALIFORNIA

REPLY BRIEF FOR THE APPELLANT

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ARGUMENT

I. The bad debt deductions

While the amount of the bad debt deductions that are here in issue, $4,196.55, is hardly *"de minimis"* (compare Taxpayer's Br. 12), the Government's primary concern is that, in allowing taxpayer the deduction that it claimed, the District Court has distorted not only the more stringent standard of proof applicable to deductions for additions to a reserve for bad debts but also the ordinary standard that is applicable to other claimed deductions. In the light of taxpayer's constantly improving bad debt experience, as the amount of its accounts receivable was increasing, the Commissioner's use of taxpayer's average experience

was certainly not an abuse of his discretion. But, more significantly, taxpayer even failed to prove that the amounts of the deductions that it claimed were reasonable. Taxpayer's evidence went only to the method used by its officers in arriving at what *they* considered to be reasonable additions for the bad debt reserve. Taxpayer offered no evidence with respect to the rates actually used and the computations of these rates, which would have permitted the Commissioner, in the first instance, and then the District Court to determine, objectively, whether the rates used were reasonable. Since the test of "reasonableness" does not refer to the subjective belief of the taxpayer or its officers but always depends on an objective determination by the Commissioner and the court (see *Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421, 423 (C.A. 4th); *R. H. Oswald Co.* v. *Commissioner,* 185 F. 2d 6, 8–10 (C.A. 7th); cf. *Yin-Shing Woo* v. *United States,* 288 F. 2d 434, 435 (C.A. 2d); *Karkus* v. *Siefert,* 169 F. Supp. 662, 666 (N.J.)), certainly, in providing that additions to a reserve for bad debt are allowable in the *discretion* of the Commissioner (1954 Code, Section 166(c)), Congress did not intend that even a good faith determination by a corporation's officers of what, in their opinion, constituted a reasonable addition would not be subject to administrative and judicial review.

II. The "debenture" payment deductions

A. The District Court's standard

Contrary to taxpayer's argument (Br. 33–34), we submit that the District Court's statement on the hear-

ing of the Government's motion to reconsider the memorandum opinion (which statement appears at pages 5 and 6 of the transcript of that hearing and which was cited in our brief (p. 21) as II–R. 194–195) lends further support to our contention (Br. 19–22) that the court applied an incorrect standard in the decision of this issue. While the court's statement suggests that it recognized that it was not sufficient that the "debentures" constituted indebtedness for state law purposes, the court still regarded the question as being whether the issuance of the "debentures" was a "subterfuge", i.e., whether there was an understanding that taxpayer's stockholders would not enforce the "debentures" according to their terms. It is clear that the District Court never reached the crucial question upon which the deductibility of the "debenture" payments depended—whether, as a matter of substantial economic reality, the payments constituted true "interest * * * on indebtedness" or "ordinary and necessary [business] expenses".

B. The "debentures"

Taxpayer attempts to uphold the District Court's holding that the "debentures" qualified as indebtedness by arguing that the greater number of the eleven factors enumerated by this Court in *O. H. Kruse Grain & Milling* v. *Commissioner,* 279 F. 2d 123, 125–126, furnished support for it. Taxpayer, however, fails to realize that the determination of whether an instrument represents a capital investment or indebtedness depends on an evaluation of the substance of the relationship that the instrument

creates between the stockholder and the corporation and that these and other factors [1] are only guides for this evaluation. We submit that, as we have shown in our opening brief (pp. 22–28), where the stockholders' advances to the corporation, in proportion to their stock interests, consist of essential assets necessary to start the corporate life and are unsecured and of extended duration (20 years)—so that they fail to comply with the arm's length standard that would be demanded by an outside creditor, where the holders of the "debentures" have personally guaranteed a continuing line of credit for the corporation and where the return to be received with respect to the "debentures" resembles the return of one making a capital investment,[2] to treat "inter-

[1] In *Kruse* this Court stated (279 F. 2d, p. 125) that "There are *at least* eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness." (Emphasis supplied.) Other relevant factors are whether the advances were part of the initial funds necessary to start the corporate life, whether the term of the instrument is an extended one, whether the instruments are secured, and whether there is any limitation on the payment of dividends or a provision for a reserve or sinking fund for payment of the instrument. See *United States* v. *Snyder Brothers Co.*, 367 F. 2d 980, 984, 985 (C.A. 5th), certiorari denied March 13, 1967 (35 U.S. Law Week 3322).

[2] The combination of facts present here distinguishes the instant case from the cases cited by taxpayer (Br. 15) (*Taft* v. *Commissioner*, 314 F. 2d 620 (C.A. 9th); *Los Angeles Shipbuilding & Drydock Corp.* v. *United States*, 289 F. 2d 222 (C.A. 9th); *Earle* v. *W. J. Jones & Son*, 200 F. 2d 846 (C.A. 9th); *Wilshire and West. Sandwiches* v. *Commissioner*, 175 F. 2d 718 (C.A. 9th); *Maloney* v. *Spencer*, 172 F. 2d 638 (C.A. 9th)) where the instruments in question were held to represent indebtedness.

est" and "redemption premium" payments with respect to the "debentures" as something other than dividends "would be to give substance to a 'transaction [which] upon its face lies outside the plain intent of the statute' [*Gregory* v. *Helvering*] 293 U.S. 465, 470." *United States* v. *Snyder Brothers Co.*, 367 F. 2d 980, 985 (C.A. 5th), certiorari denied March 13, 1967 (35 U.S. Law Week 3322).

C. The "redemption premium" payments

Taxpayer, not disputing the fact that the purported "redemption premium" payments were wholly unreasonable in amount (Govt. Br. 26, 29), now argues (Br. 32–33) that the issue of whether or not these payments were deductible was not raised in the court below. This contention is, however, clearly without merit; for the pre-trial conference order shows that taxpayer recognized (I–R. 131) that the issue of whether the "redemption premium" payments were deductible was being raised by the Government as an independent question. In order to obtain a deduction for these payments taxpayer was required to prove

that the amounts paid qualified under a statutory provision authorizing a deduction. *Reinecke* v. *Spalding*, 280 U.S. 227, 232–233.

Respectfully submitted.

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APRIL, 1967.

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Attorney

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